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IN THE

Supreme Court of the United States

DEPARTMENT OF REVENUE OF THE COMMONWEALTH OF KENTUCKY AND FINANCE AND ADMINISTRATION CABINET OF THE COMMONWEALTH OF KENTUCKY,
Petitioners,

v.

GEORGE W. DAVIS AND CATHERINE V. DAVIS,
Respondents.

On Writ of Certiorari to the Kentucky Court of Appeals

BRIEF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION, NATIONAL GOVERNORS ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL CONFERENCE OF STATE LEGISLATURES, NATIONAL ASSOCIATION OF COUNTIES, COUNCIL OF STATE GOVERNMENTS, U.S. CONFERENCE OF MAYORS, INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION, AND INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION AS *AMICI CURIAE* SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether Kentucky's income tax exemption for interest on municipal bonds issued by the Commonwealth or its political subdivisions violates the dormant Commerce Clause because Kentucky does not exempt interest earned by Kentucky taxpayers on bonds issued by other States or their political subdivisions.

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INTEREST OF THE *AMICI CURIAE*

Amici are organizations whose members include state, county, and municipal governments and officials throughout the United States.[1] *Amici* have a compelling interest in all legal issues affecting the essential workings of state and local government finance, including the constitutionality of state laws that exempt municipal bond interest from taxation. They accordingly submit this brief to assist the Court in the resolution of this case.

SUMMARY OF ARGUMENT

1. Historical and pragmatic considerations provide compelling reasons to uphold Kentucky's income tax exemption for the interest earned on municipal bonds issued by the Commonwealth and its political subdivisions.

First, since the advent of state personal income taxes in the early 1900s, the States have maintained exemptions similar or identical to Kentucky's that favor in-state municipal bonds. Congress has long been aware of these exemptions and plainly has the authority to regulate the state taxation of interstate commerce. Yet it has never seen fit to prohibit this practice. Where Congress has left undisturbed a longstanding and nearly universal state tax policy, its tacit approval is entitled to substantial respect, as this Court has recognized.

Second, a decision by this Court to invalidate Kentucky's exemption would impose significant economic hardships on the States. Presently, the overwhelming majority of States exempt some or all in-state municipal bond interest from personal income taxation while taxing the interest earned on

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[1] The parties have filed blanket consents to the filing of *amicus* briefs in this case. Pursuant to Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amici*, their members, or their counsel made a monetary contribution to the preparation or submission of this brief.

out-of-state municipal bonds. Prior to the decision below, state governments had no reason to believe that these exemptions might be unconstitutional, and have structured their fiscal affairs accordingly for almost a century. Precisely because so many States and local governments have incurred immense financial obligations based on these understandings, a decision to invalidate Kentucky's tax scheme would drain state treasuries of billions of dollars, transition costs that are manifestly unfair given the States' longstanding and reasonable reliance on the exemptions' constitutionality.

Finally, the principal reason state governments would incur these costs is that this Court's decision might well apply retroactively. States could be forced to refund all recently paid taxes on out-of-state municipal bond interest, and most would effectively be required to forego taxing the interest on all outstanding out-of-state municipal bonds. Only Congress could craft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued. It therefore makes sense for the Court to stay its hand, as it has done before in state tax decisions raising similar issues of institutional competence. Even if a rule requiring the States to tax in-state and out-of-state bonds equally could be shown to be good policy, Congress is the branch of government best positioned to fashion a political solution in such a complex area with massive fiscal ramifications.

2. In *United Haulers Assn., Inc.* v. *Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007), this Court held that state laws that "favor the government," that "treat every private business, whether in-state or out-of-state, exactly the same," and that concern "a traditional government activity," "do not discriminate against interstate commerce for purposes of the Commerce Clause." *Id.*, at 1790. Kentucky's personal income tax exemption for interest earned on in-state municipal bonds meets each of these criteria. It favors the government, as the exemption applies only to interest on bonds issued by Kentucky and its political subdivisions. It

provides no advantage to Kentucky businesses over their out-of-state competitors. And it concerns a governmental activity that dates to the colonial period and, like waste management in *United Haulers*, is central to state and local governments' ability to carry out their governmental obligations. Thus, Kentucky's tax exemption does not discriminate against interstate commerce.

Because Kentucky's tax exemption is not discriminatory, it is constitutional if it does not impose a burden on interstate commerce that is "clearly excessive in relation to the putative local benefits." *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137, 142 (1970). The exemption's local benefits are substantial, while its economic impact is not properly understood as a "burden" on interstate commerce for purposes of the dormant Commerce Clause, let alone one that is "clearly excessive." The exemption's principal effect is to shift the geographic distribution of the investors purchasing a given State's municipal bonds, such that a larger proportion of those investors holding Kentucky municipal bonds are Kentucky residents. But this is a natural and salutary consequence of the distinctive relationship between a sovereign and its citizens, not a distortion of interstate commerce.

ARGUMENT

I. STATE GOVERNMENTS HAVE REASONABLY RELIED ON THE CONSTITUTIONALITY OF TAX EXEMPTIONS LIKE KENTUCKY'S, AND CONGRESS IS IN THE BEST POSITION TO ALTER THE STATUS QUO

Since the inception of modern state income taxes during the Progressive Era, state governments have granted preferential tax exemptions for the interest earned on in-state municipal bonds and have had no reason to question their validity. Congress plainly has the authority under the Commerce Clause to regulate the States' taxation of interstate

commerce, yet it has never seen fit to interfere with this practice. Although this Court is generally reluctant to draw inferences from congressional silence, in this particular context Congress's inaction warrants significant consideration, especially given the extensive evidence of Congress's awareness of the practice. Currently, 42 States provide income tax preferences for in-state municipal bonds, and myriad state and local governments have structured their budgets in reliance on these exemptions' constitutionality. Consequently, a decision to invalidate Kentucky's tax scheme would force state treasuries to absorb billions of dollars in transition costs, a large-scale financial disruption that is manifestly unfair given the reasonableness of the States' reliance on the validity of a ubiquitous tax policy.

The principal reason the States would incur these costs is that this Court's decision could apply retroactively. State governments might be forced to refund hundreds of millions of dollars in taxes paid on out-of-state municipal bond interest, and most States would effectively be required to forego taxing the interest on all outstanding out-of-state municipal bonds. Only Congress could craft a purely prospective remedy that applied solely to municipal bonds that have not yet been issued. These practical considerations suggest that the Court should stay its hand, as it has done in several prior state tax decisions raising similar issues of institutional competence. For even if one concluded that interstate commerce might benefit from the States' equal treatment of in-state and out-of-state municipal bonds, Congress is the only institution capable of crafting an equitable transition to such a regime.

A. Longstanding Historical Practice Supports the Constitutionality of State Tax Exemptions for Interest Paid on In-State Municipal Bonds

American state and local governments have imposed various forms of personal income taxes since the colonial

period. See 2 J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 20.01 (2007). Wisconsin enacted the first modern personal income tax in 1911, and several other States quickly followed suit. See *id.* From their inception, these state income tax codes have exempted the interest earned on municipal bonds issued by the taxing State, and they have denied this benefit to the interest earned on bonds issued by their sister States. New York adopted such a preference in 1919, see 1919 N.Y. Laws 1641–42, North Carolina in 1921, see 1921 N.C. Sess. Laws 207-208, and Virginia in 1926, see 1926 Va. Acts 961. Today, 42 States offer some form of tax preference for the interest earned on in-state municipal bonds.[2] And until the Kentucky Court of Appeals' handed down its decision in this case, no court in the United States, state or federal, had held that this differential tax treatment of in-state and out-of-state municipal bonds was unconstitutional. See 1 Hellerstein & Hellerstein, ¶ 4.13.

As this Court has recognized on several occasions, Congress "unquestionably" has the authority under the Commerce Clause to regulate the States' taxation of interstate commerce. *Camps Newfound/Owatonna, Inc.* v. *Town of Harrison*, 520 U.S. 564, 572 (1997). See also *Quill Corp. v. North Dakota*, 504 U.S. 298, 318 (1992); *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 280 (1978); *Prudential Ins. Co.* v. *Benjamin*, 328 U. S. 408, 434 (1946). And Congress has invoked this authority on numerous occasions to protect interstate commerce from various burdens it has deemed inconsistent with the national interest. See, e.g., Pub. L. No. 86–272, 73 Stat. 55, codified at 15 U.S.C. §381 (prohibiting the States from imposing income taxes on businesses that keep their contacts within the taxing State beneath a specific threshold); Internet

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[2] Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose no taxes on personal income, 2 Hellerstein & Hellerstein ¶ 20.01 n. 5, while Indiana does not distinguish in-state from out-of-state municipal bonds, see Ind. Code Ann. § 6–3–1–3.5.

Tax Nondiscrimination Act, Pub. L. No. 108–435, 118 Stat. 2615 (2004) (prohibiting States from imposing taxes on internet access or "discriminatory taxes on electronic commerce"); Pub. L. No. 104–95, 109 Stat. 979, codified at 4 U.S.C. §114 (restricting the States' authority to tax the retirement income of nonresidents); Soldiers' and Sailors' Civil Relief Act of 1940, Act of Oct. 17, 1940, ch. 888, § 514, as amended, 50 App. U.S.C. §571 (limiting the States' power to tax the property and personal income of military personnel); Railroad Revitalization and Regulatory Reform Act of 1976 (the 4-R Act), Pub. L. No. 94–210, 90 Stat. 54, codified at 49 U.S.C. §11501 (prohibiting States from imposing higher taxes on railroad property than on other commercial or industrial property).[3]

States have maintained these tax preferences for their own municipal bonds for nearly a century, and Congress has plainly been aware of the practice. See Br. *Am. Cur.* North Carolina et al. at 19-21 (collecting cases and legislative authorities); Br. *Am. Cur.* National Association of State Treasurers at 14-16 (same). Yet Congress, though it "has the power to protect interstate commerce," "is so far content to

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[3] *See also* 15 U.S.C. §391 (prohibiting the States from imposing a tax on "the generation or transmission of electricity which discriminates against out-of-State manufacturers, producers, wholesalers, retailers, or consumers of that electricity"); Pub. L. No. 94–29, 89 Stat. 97, codified at 15 U.S.C. §78bb(d) (limiting the States' power to impose stock transfer taxes); Employee Retirement Income Security Act (ERISA), 29 U.S.C. §1144(a) (dictating that ERISA "shall supersede any and all State laws insofar as they now or hereafter relate to any employee benefit plan," including state tax laws); 49 U.S.C. §§14502(b), 40116(d)(2)(A) (extending the protections of the 4-R Act to property owned by motor and air carriers); 49 U.S.C. §§14505, 40116(b) (prohibiting the States or their political subdivisions from taxing the interstate transportation of passengers by motor carrier or in air commerce); 49 U.S.C. §40116(c) (permitting state or local taxes "related to a flight of a commercial aircraft or an activity or service on the aircraft only if the aircraft takes off or lands in the State or political subdivision as part of the flight").

let the matter rest." *Commonwealth Edison Co.* v. *Montana*, 453 U. S. 609, 637 (1981) (White, J., concurring)

To be sure, "[s]tanding alone, historical patterns cannot justify contemporary violations of constitutional guarantees," *Marsh* v. *Chambers*, 463 U.S. 783, 790 (1983), and "[t]his Court generally is reluctant to draw inferences from Congress' failure to act," *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 306 (1988). Moreover, the Court has stated that Congress must indicate its intent with "unmistakable clarity . . . to permit state regulation that discriminates against interstate commerce." *Barclays Bank PLC* v. *Franchise Tax Bd. of Cal.*, 512 U. S. 298, 323 (1994). See also *Wyoming* v. *Oklahoma*, 502 U.S. 437, 458 (1992). But, for the reasons set out in Part II *infra*, Kentucky's tax exemption does not discriminate against interstate commerce. And the Court has acknowledged that, when the question at hand concerns whether the States' tax policies impermissibly burden interstate commerce, Congress's silence is important. See *General Motors Corp.* v. *Tracy*, 519 U. S. 278, 304–305 (1997); *Joseph* v. *Carter & Weekes Stevedoring Co.*, 330 U.S. 422 (1947), overruled on other grounds, *Department of Revenue of Wash.* v. *Association of Wash. Stevedoring Cos.*, 435 U. S. 734 (1978).

In *Carter & Weekes Stevedoring*, the Court held that, because "the power lies in Congress under the [Commerce] Clause to make any desired adjustment in the taxation area, its acquiescence in [this Court's] former rulings on state taxation indicates its agreement with the adjustments of the competing interests of commerce and necessary state revenues." 330 U.S., at 428. Of course, the Court has not squarely addressed whether the economic burdens and benefits attributable to tax exemptions like Kentucky's are consistent with the dormant Commerce Clause. In this case there is no *judicial* ruling in which Congress has acquiesced; instead, Congress has tacitly endorsed a widespread, long-

standing, and uninterrupted practice by the States that, until very recently, has gone unchallenged. But this distinction should have no constitutional significance. In our federal system—and with respect to a matter that Congress is expressly charged by the Constitution to superintend, see Art. I, §8, cl. 3—Congress's tacit approval of the States' consistent and longstanding judgments should be entitled to the same consideration and respect as its silent approval of this Court's holdings.

B. A Judicial Declaration that Kentucky's Tax Exemption Is Unconstitutional Would Disrupt the States' Substantial Reliance Interests

In light of the exemptions' deep historical roots, all but eight States have structured their financial affairs around the assumption that providing a tax preference for the interest earned on in-state municipal bonds is constitutional. A decision by this Court to invalidate Kentucky's tax scheme would therefore impose severe financial hardships on state governments, transition costs that are patently unfair given the States' reasonable reliance on the constitutionality of exemptions like Kentucky's.

Perhaps these consequences would not be disquieting had the States persisted in imposing income taxes that they had good reason to believe were unconstitutional. Cf. *McKesson Corp.* v. *Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18, 46–50 (1990) (discussing Florida's continued imposition of a liquor tax that was blatantly protectionist and only cosmetically different from a Hawaii liquor tax that the Court had previously invalidated). But that is not the case here. The States, like most other observers, were caught completely off guard by the Kentucky Court of Appeals' decision. See T. DeSue, *Ky. Ruling Would Lift Tax on Out-of-State Bonds*, Bond Buyer, Jan. 10, 2006, at 1 (quoting a bond industry executive who called the decision "earth shattering"). Before

January 2006, state governments had little reason to believe that these tax exemptions were constitutionally suspect, and they acted accordingly. To force the States to shoulder these breathtaking transition costs, despite their reasonable and substantial reliance on extant understandings of the dormant Commerce Clause, is wholly inequitable.

To appreciate what is at stake for the States, it is useful to isolate the implications of this case for two distinct (but overlapping) groups of taxpayers. The first group is taxpayers who have recently paid state income tax on interest earned on out-of-state municipal bonds. The second and far more significant group is taxpayers who presently own out-of-state municipal bonds. With respect to the first group, a decision to invalidate Kentucky's tax exemption may well require the States to disgorge hundreds of millions of dollars in tax refunds. With respect to the second group, it would effectively force the States to forego *billions* of dollars in income tax revenue well into the future. These are dollars on which the States' budgets critically depend. And these are transition costs that the States would be forced to shoulder merely because they have incurred debt obligations based on a reasonable understanding of the dormant Commerce Clause.

1. *Taxpayers who have recently paid taxes on interest earned on out-of-state municipal bonds.* As a threshold matter, there is a significant possibility that a ruling by this Court to invalidate Kentucky's tax exemption would apply retroactively. Granted, this Court's precedent has "left unresolved the precise extent to which the presumptively retroactive effect of this Court's decisions may be altered in civil cases." See *Harper* v. *Virginia Dept. of Taxation*, 509 U.S. 86, 96 (1993). But the Court held in *Harper* that "[w]hen this Court applies a rule of federal law to the parties before it, that rule . . . must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate our

announcement of the rule." 509 U.S., at 97. Thus, a decision invalidating Kentucky's tax exemption could apply retroactively to all similarly situated taxpayers nationwide.

Further, the Due Process Clause could require that this retroactive remedy "provide meaningful backward-looking relief to rectify any unconstitutional deprivation." *McKesson*, 496 U.S., at 31. In a case like this, where the claim is that the State's tax scheme discriminates against interstate commerce, such relief could take three forms, any of which would remedy the constitutional problem: (1) the States could refund all taxes paid on any interest earned on out-of-state municipal bonds; (2) the States could retroactively impose a tax on any interest earned on in-state municipal bonds; or (3) the States could enact some combination of the two that results in the equal tax treatment of all municipal bond interest during the relevant time period. See *id.*, at 40–41.

Although each of these options would be open to the States in theory, "[i]n the real world, . . . the practical and political difficulties of fashioning any retroactive remedy other than a refund (as well as legal difficulties presented by federal and state strictures regarding retroactive legislation) make solutions that require back-tax collections unlikely." W. Hellerstein & D. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 Cornell L. Rev. 789, 873 (1996). Thus, the States could be required to award refunds to every taxpayer who had paid income tax on interest earned on out-of-state municipal bonds within the relevant limitations period, unquestionably a substantial liability. For instance, in 2003 New York residents reported $636.4 million of interest income from out-of-state municipal bonds. D. Denison et al., *Davis v. Department of Revenue of Kentucky: A Preliminary Impact Assessment*, IFIR Working Paper No. 2007–03 (2007), at pp. 13–14, available at http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2007-03.pdf (last visited July 16, 2007). New York's

estimated tax revenue from this interest was $45.8 million. *Id.*, at 14. For Connecticut, the estimated income tax revenue in 2004 from out-of-state municipal bond interest and the dividends paid by municipal bond mutual funds was $70.9 million. *Id.* Thus, the immediate tax refund liability for the States as a whole could run well into the hundreds of millions of dollars.

2. *The tax treatment of outstanding municipal bonds.* While substantial, the States' immediate liability for tax refunds would pale in comparison to the fiscal consequences related to the taxation of the interest yet to be earned on outstanding out-of-state municipal bonds. Again, a decision invalidating Kentucky's tax exemption would require the States to treat all municipal bonds equally. For the interest earned on municipal bonds that have already been issued, the States would have two choices in providing an adequate remedy: (1) they could tax the interest earned on in-state municipal bonds, or (2) they could exempt the interest earned on out-of-state municipal bonds.

For most States, the option of taxing the interest earned on in-state municipal bonds that investors have already purchased would be impracticable, if not legally foreclosed. In-state investors have purchased these bonds in reliance on their favorable state tax treatment. For most in-state investors, the state tax exemption is a critical aspect of the transaction: They have accepted a lower yield in exchange for the state income tax benefit, such that they still receive a competitive after-tax rate of return on their investment. Thus, taxing the interest on in-state municipal bonds that taxpayers have already acquired would be inequitable, if not a breach of contract. It would change the rules on the bondholders midstream, forcing them to accept an after-tax rate of return well below that of comparable investments.

This means that to treat in-state and out-of-state municipal bonds equally, most States would likely be forced to abstain

from taxing any interest earned by their taxpayers on outstanding out-of-state municipal bonds. The fiscal repercussions of such a mandate would be astounding. As discussed above, the revenue loss for the States *for a single year* would run well into the hundreds of millions of dollars. See Denison et al., *supra*, at pp. 13–14. Given that many outstanding bonds will not mature for another thirty years, affirmance of the judgment below would cost state governments billions of dollars in foregone tax revenue.

C. If a Change in the State Tax Treatment of Municipal Bond Interest Is Desirable, Congress Is in the Best Position to Make that Change

For the reasons discussed in Part II, *infra*, *amici* believe that Kentucky's tax exemption is constitutional. Even if respondents were correct on the law, however, all of the attendant transition costs could be avoided if the substantive rule that they seek—the equal state tax treatment of in-state and out-of-state municipal bonds—could be applied purely prospectively. That is, these financial dislocations would disappear if any mandate of equal tax treatment were to apply only to municipal bonds issued in the future. For the reasons discussed earlier, however, this Court generally cannot fashion such relief. The only branch of government capable of adopting such a rule, without simultaneously imposing massive costs on state treasuries, is Congress.

There is a strong tradition of this Court deferring to Congress's superintendence of interstate commerce in cases raising similar issues of institutional competence, particularly when they involve matters of state and local taxation. For example, *Moorman Mfg. Co.* v. *Bair* addressed Iowa's single-factor formula for apportioning the income of interstate businesses. The plaintiffs demonstrated that Iowa's method of apportionment likely subjected a number of out-of-state taxpayers to multiple taxation, and thus disadvantaged inter-

state commerce. See 437 U.S., at 276–277. But the Court reasoned that it was ill-suited to resolve the controversy, as doing so would have effectively required the Court to choose a particular method of apportioning income under the guise of interpreting the dormant Commerce Clause, which it declined to do. *Id.*, at 278–280. "It is clear," the Court held, "that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions." *Id.*, at 280.

Commonwealth Edison Co. v. *Montana* involved a severance tax that Montana imposed on all coal mined in the State. Because the tax rate was extremely high, and because its incidence fell predominantly on out-of-state electricity consumers, the plaintiffs asserted that Montana had effectively exported its tax burden to other States. See 453 U.S., at 617–618. But because a holding in favor of the taxpayers would have forced the Court to make a range of difficult empirical economic judgments, it upheld the State's tax scheme and left the ultimate resolution to Congress: "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress, when particular state taxes are thought to be contrary to federal interests." *Id.*, at 628. Despite some reservations, this Court declined to intervene. See *id.*, at 637 (White, J., concurring) ("This is a very troublesome case for me, and I join the Court's opinion with considerable doubt and with the realization that Montana's levy on consumers in other States may in the long run prove to be an intolerable and unacceptable burden on commerce" but "Congress has the power to protect interstate commerce from intolerable or even undesirable burdens").

Perhaps the most analogous case is *Quill Corp.* v. *North Dakota*, which addressed whether a State could require an out-of-state vendor to collect use taxes on sales to the taxing State's consumers, even when the vendor had no physical presence in the taxing State. See 504 U.S. at 301. The Court had invalidated an identical collection obligation 25 years earlier in *National Bellas Hess, Inc.* v. *Department of Revenue of Ill.*, 386 U. S. 753 (1967), and "the *Bellas Hess* rule . . . engendered substantial reliance and has become part of the basic framework of a sizable industry." *Quill*, 504 U.S., at 317. Despite some evident ambivalence, see *id.*, at 315, 317 (conceding that the physical presence requirement "appears artificial at its edges" and that the Court had rejected a "similar bright-line, physical-presence requirement" in other state tax cases), the Court reaffirmed the rule of *Bellas Hess*. It concluded that, although there were problems with the rule, Congress was in the best position to alter the status quo. See *id.*, at 317–318. "[T]he underlying issue is not only one that Congress may be better qualified to resolve, but also one that Congress has the ultimate power to resolve. No matter how we evaluate the burdens that use taxes impose on interstate commerce, Congress remains free to disagree with our conclusions." *Id.*, at 318 (footnote omitted).

Moorman, *Commonwealth Edison*, and *Quill* together represent a critical strand of this Court's dormant Commerce Clause jurisprudence. Specifically, they show that even when state laws arguably burden interstate commerce, the judicial disruption of the status quo may not be the wisest course, particularly in the field of taxation. Reasons of institutional competence can dictate that the controversy is simply not meet for judicial resolution.

This is such a case. Even assuming some change in state tax treatment of bond interest were needed, Congress is the only institution capable of devising an equitable transition to a system in which the States' tax the interest on in-state and out-of-state municipal bonds equally. Cf. *United Haulers*,

127 S. Ct. at 1797 n. 7 ("Congress retains authority under the Commerce Clause as written to regulate interstate commerce, whether engaged in by private or public entities.").

In the concluding paragraph of the majority opinion in *Quill*, the Court offered the following insight:

> [E]ven if we were convinced that *Bellas Hess* was inconsistent with our Commerce Clause jurisprudence, this very fact might give us pause and counsel withholding our hand, at least for now. Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. In this situation, it may be that the better part of both wisdom and valor is to respect the judgment of the other branches of the Government.

504 U.S., at 318–19 (internal quotation marks, alterations, and citations omitted). The same is true here. Given the enormous reliance interests at stake, Congress is the branch of government best suited to craft a solution if one is needed.

II. UNDER *UNITED HAULERS*, KENTUCKY'S TAX EXEMPTION FOR INTEREST EARNED ON IN-STATE MUNICIPAL BONDS DOES NOT VIOLATE THE DORMANT COMMERCE CLAUSE

In *United Haulers*, this Court held that state laws granting a preference to the government generally do not discriminate against interstate commerce for purposes of the dormant Commerce Clause. Specifically, "laws favoring local government" with respect to "a customary and traditional government function," but which treat "all private companies exactly the same," "do not discriminate against interstate commerce." 127 S. Ct., at 1795–1797 & n. 7 (order of quotations altered). The tax exemption challenged here meets all three of these criteria. It favors the government, as it only covers interest earned on bonds issued by Kentucky and its municipalities; it treats all private businesses exactly the

same; and it concerns an activity—borrowing money—that is a traditional and core governmental function. It therefore does not discriminate against interstate commerce. Finally, because the economic impact of Kentucky's tax exemption is not a cognizable "burden" on interstate commerce, let alone one that is clearly excessive relative to its local benefits, the exemption does not violate the dormant Commerce Clause.

A. A State Tax Exemption for Interest Earned on Bonds Issued by the Taxing State and Its Political Subdivisions Does Not Discriminate Against Interstate Commerce

In *United Haulers*, a coalition of waste haulers contended that two county "flow control" ordinances violated the dormant Commerce Clause. In particular, they argued that the ordinances discriminated against interstate commerce because they prohibited the haulers from delivering trash to out-of-state processing facilities at lower cost. *Id.*, at 1792. The Court had confronted a nearly identical ordinance thirteen years earlier in *C & A Carbone, Inc.* v. *Clarkstown*, 511 U.S. 383 (1994), and found the regulation unconstitutional. The "only salient difference" between the two cases was that the favored facility in *Carbone* was privately owned, whereas the favored facilities in *United Haulers* were owned and operated by local government. *United Haulers*, 127 S. Ct., at 1790.

This sole difference was "constitutionally significant"—indeed, dispositive—leading the Court to conclude that the flow control ordinances did not discriminate against interstate commerce. *Id.* As the Court noted, there are several "[c]ompelling reasons" that justify treating laws that benefit the government differently from those that benefit in-state private businesses under the dormant Commerce Clause. *Id.*, at 1795.

First, unlike private businesses, "government is vested with the responsibility of protecting the health, safety, and welfare

of its citizens." *Id.* (citing *Metropolitan Life Ins. Co. v. Massachusetts*, 471 U.S. 724, 756 (1985)). Laws favoring state and local governments therefore "may be directed toward any number of legitimate goals unrelated to protectionism." *Id.*, at 1796. Second, treating public and private entities alike for purposes of the dormant Commerce Clause "would lead to unprecedented and unbounded interference by the courts with state and local government." *Id.* Though the Commerce Clause plays an important role in preventing state and local governments from engaging in economic protectionism, it "is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake." *Id.* Finally, courts should be "particularly hesitant to interfere with [government] efforts under the guise of the Commerce Clause" when the activities in question are "both typically and traditionally a local government function." *Id.* (internal quotation marks and citation omitted).

The essential holding of *United Haulers* was succinct: "laws that favor the government" in areas of "traditional government activity," but which "treat every private business, whether in-state or out-of-state, exactly the same," "do not discriminate against interstate commerce for purposes of the Commerce Clause." *Id.*, at 1790. The logic of that holding dictates that Kentucky's tax exemption is not discriminatory.

First, Kentucky's tax exemption favors the Commonwealth and its political subdivisions, not private business interests. Because of the tax exemption, Kentucky taxpayers are willing to accept a lower pre-tax rate of return on in-state municipal bonds. This means that Kentucky and its political subdivisions can issue their bonds at a considerably lower interest rate than the market would require absent the exemption. Thus, the beneficiaries of the tax exemption are not Kentucky bondholders; the market largely accounts for their favorable tax treatment by reducing their yield on the

tax-preferred bonds. See Cole et al., *The Capitalization of the State Tax Exemption Benefit in Municipal Bond Yields*, 7 J. Financial & Strategic Decisions 67, 68 (1994), available at http://www.studyfinance.com/jfsd/pdffiles/v7n2/cole.pdf (last visited July 16, 2007) (finding 100% capitalization of the state tax exemption benefit in the yield of municipal bonds).

The beneficiaries are the Commonwealth and its political subdivisions, which are able to borrow at a considerably lower interest rate, reducing their costs in raising capital. This, in turn, enables them to finance a range of public services and public works. See J. W. Temel, *The Fundamentals of Municipal Bonds* 53–55 (5th ed. 2001) (explaining that lower debt-service costs enable state and local governments to finance such public works as schools, roads, bridges, airports, public power facilities, sewers, hospitals, fire stations, affordable housing, mass transit facilities, and universities).[4] Of course, it is conceivable that the tax exemption

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[4] Municipal bonds fall into two basic categories: governmental bonds and private activity bonds. *See* C. Belmonte, *Tax-Exempt Bonds, 1996–2002* at 151-52 (SOI Bulletin Summer 2005), available at http://www.irs.gov/pub/irs-soi/02govbnd.pdf (last visited July 17, 2007). Governmental bonds have no statutory definition. See Public Finance Network, *Tax-Exempt Financing: A Primer* 3 (rev. ed., n.d.). They are generally issued to finance facilities that are owned, controlled, and operated by state or local governments, such as schools, streets, and utilities. *See id.*, at 2; Belmonte, *supra*, at 155.

Private activity bonds are defined by § 141 of the Internal Revenue Code. *See* 26 U.S.C. §141. In brief, a municipal obligation will be considered a private activity bond, "irrespective of the purpose for which it is issued or the source of payment, if (1) more than 10 percent of the proceeds of the issue will finance property that will be used by a nongovernmental person in a trade or business, and (2) the payment of debt service on more than 10 percent of the proceeds of the issue will be (A) secured by property used in a private trade or business or payments in respect of such property, or (B) derived from payments in respect of property used in a private trade or business." Temel, *supra*, at 251. Roughly three-fourths of the municipal bond market consists of govern-

actually costs Kentucky more in foregone tax revenue than it delivers in reduced borrowing costs. See Cole et al., *supra*, at 68, 72. But the relevant point for purposes of *United Haulers* is that, to the extent the exemption provides a benefit, that benefit runs to the government.[5]

Second, Kentucky's tax scheme treats all private business interests identically. The Kentucky tax code includes all bond interest in income, with the sole exception of the interest earned on bonds issued by the Commonwealth or its political subdivisions. See Ky. Rev. Stat. Ann. §§ 141.010(9), 141.010(10)(c). Every private issuer of debt is treated the same, regardless of its location. The law grants no advantage to Kentucky businesses—whether they are bond issuers, bond dealers, bond brokers, or bond holders—over their out-of-state competitors.[6]

Consequently, Kentucky's tax exemption does not represent the sort of economic protectionism with which the dormant Commerce Clause is chiefly concerned. This is not a law that "burden[s] out-of-state producers or shippers simply to give a competitive advantage to in-state *businesses*." *Granholm* v. *Heald*, 544 U.S. 460, 472 (2005) (emphasis added). Nor is it a law that "give[s] local consumers

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mental bonds, and one-fourth of private activity bonds. *See* Belmonte, *supra*, at 151 (between 1996 and 2002 more than $1.5 trillion in governmental bonds and $548 billion in private activity bonds were issued).

[5] As discussed in more detail *infra* at 20 & 25-26, Kentucky's exemption also furthers the legitimate objectives of decentralizing control over the Commonwealth's fiscal affairs and encouraging more state citizens to become genuine stakeholders in their community.

[6] Of course, the issuance of municipal bonds will produce benefits for private contractors that perform the projects that are financed by the bonds. But the same is true of any public spending, whether financed through bonds, taxes, license fees, or a grant from the federal government. This Court has never considered the existence of such benefits, in itself, "protectionist."

an advantage over consumers in other States." *Brown-Forman Distillers Corp.* v. *New York State Liquor Auth.*, 476 U. S. 573, 580 (1986).

Instead, the exemption operates as an implicit, intrastate transfer from the Commonwealth's pool of general revenue to those governmental units (including the Commonwealth itself) that choose to raise capital through the issuance of municipal bonds. The decision whether to issue municipal bonds is vested by state law in various governmental units and, through elections, their respective constituents. When these governments issue debt, the exemption offers an implicit subsidy by reducing the interest rate that the market will demand. The cost of this subsidy, however, is fully funded by Commonwealth itself: The Kentucky government must pay for it by relinquishing personal income tax revenue. In this sense, the tax exemption is indistinguishable in practical effect from a program under which the Commonwealth offered no tax exemption but made direct cash payments to its municipalities when they issued bonds, a program that would plainly be constitutional.

The exemption is therefore best understood as a policy choice by the Commonwealth about how to structure the financing of its various governmental units. Through the mechanism of the exemption, Kentucky has decided (1) to raise less revenue through personal income taxes and more through municipal bond issues, and (2) to decentralize the decisionmaking process concerning how much capital to raise and which public works to pursue. Those governmental units with the authority to issue bonds are empowered to use state general funds (in the form of foregone income tax revenue) to pursue projects that they believe are beneficial to their respective jurisdictions. Structuring state and municipal finances in this fashion is thus a political choice. And like the decision by Oneida and Herkimer Counties and New York State to displace private competition in waste processing with

a government-run monopoly, "nothing in the Commerce Clause vests the responsibility for that policy judgment with the Federal Judiciary." *United Haulers*, 127 S. Ct., at 1796.

Finally, the activity of borrowing money to finance the construction of infrastructure and other necessary public improvements is a "traditional government function." First, the practice has deep historical roots, predating the issuance of corporate debt by several centuries. See Temel, *supra*, at 49 (noting that Italian city-states borrowed from major merchant banking families during the Renaissance). American cities incurred debt as early as the seventeenth century. See *id.* New York City issued the first officially recorded municipal bond in 1812 to finance the construction of the Erie Canal. See Shafroth, *Which State Taxes Are 'Preferred' for Infrastructure?*, 40 State Tax Notes 237 (2006). By 1843, U.S. cities had accumulated approximately $25 million in outstanding debt, and the number of municipal bond issues has grown exponentially ever since. See Temel, *supra*, at 49–50. State and local governments issued $26 billion in municipal bonds in 1975, and they issued more than ten times that amount ($263.8 billion) in 1999. See *id.*, at 3. Presently, the value of outstanding U.S. municipal bonds is roughly $2.4 trillion. See T. Herman, *Justices to Hear Muni-Bond Case—Kentucky Tax Fight Over Exemptions Affects Many States*, Wall St. J., May 22, 2007, at D3.

Second, and more fundamentally, borrowing money is indispensable to state and local governments' capacity to provide essential but costly governmental services. See *South Carolina* v. *Baker*, 485 U.S. 505, 531 (1988) (O'Connor, J., dissenting) ("Long-term debt obligations are an essential source of funding for state and local governments."). There are approximately 87,000 state and local governments in the United States, U.S. Census Bureau, *Statistical Abstract of the United States: 2007*, at p. 264 (Table 415), and only the very largest are capable of financing any significant capital im-

provements exclusively from current revenue. Even for state governments, issuing bonds is often the only practical means to finance the construction of essential infrastructure, such as roads, highways, sewers, and utilities. Bond issues make these public investments possible by allowing state and local governments to spread the relevant tax burden over several years.

Issuing bonds is thus a temporal extension of a State's authority to tax, a power that is "basic to its sovereignty." *Bode* v. *Barrett*, 344 U.S. 583, 585 (1953). Municipal bonds permit governments to extend the time frame of taxation over the useful life of the capital improvement, rather than forcing them to impose the entire tax burden at the time of the improvement's construction. Moreover, bonds promote fairness in public finance by enabling state and local governments better to ensure that the citizens who benefit from long-term capital improvements (those who live in the community over the life of the assets) are those who pay for them (in taxes that go toward servicing the debts). Absent such a spreading of the tax burden, taxpayers required to fund the entire cost of public works at the time of their construction would have a strong incentive to undersupply these important public goods. Thus, there are powerful systemic reasons that local governments have incurred debt since colonial times, and that they continue to rely on it heavily today.

In short, Kentucky's tax exemption falls squarely within the rule announced in *United Haulers*: It favors state and local government, it treats all private businesses equally, and it concerns a traditional government activity. It necessarily follows that, for purposes of the dormant Commerce Clause, Kentucky's income tax exemption for interest earned on in-state municipal bonds does not discriminate against interstate commerce.

B. Kentucky's Tax Exemption Does Not Impose a "Clearly Excessive" Burden on Interstate Commerce

Because Kentucky's tax exemption does not discriminate against interstate commerce, the appropriate test under the dormant Commerce Clause is that set out in *Pike* v. *Bruce Church, Inc.*, 397 U.S. 137 (1970), for laws that are "directed to legitimate local concerns, with effects upon interstate commerce that are only incidental." *City of Philadelphia* v. *New Jersey*, 437 U.S. 617, 624 (1978).[7] To pass muster, Kentucky must only show that the burden on interstate commerce attributable to the tax exemption is not "clearly excessive in relation to the putative local benefits." *Pike*, 397 U.S., at 142. Kentucky has made that showing here.[8]

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[7] Since 1977, this Court has typically applied the 4-part test originally articulated in *Complete Auto Transit, Inc.* v. *Brady*, 430 U. S. 274 (1977), to determine whether a challenged state tax provision is consistent with the dormant Commerce Clause. See, e.g., *Oklahoma Tax Comm.* v. *Jefferson Lines, Inc.*, 514 U. S. 175, 183 (1995); *Itel Containers Int'l Corp.* v. *Huddleston*, 507 U. S. 60, 73 (1993); *Trinova Corp.* v. *Michigan Dept. of Treasury*, 498 U. S. 358, 372 (1991); *Goldberg* v. *Sweet*, 488 U. S. 252, 259–260 (1989). Under *Complete Auto*, a state tax is permissible so long as it "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto*, 430 U.S., at 279. Here, Respondents' only Commerce Clause claim appears to be that Kentucky's tax exemption discriminates against interstate commerce. See J.A. 24. Thus, if the Court concludes that the exemption is non-discriminatory, further analysis under *Pike* may be unnecessary. Cf. *General Motors v. Tracy*, 519 U.S. at 824 n. 12 (suggesting that *Pike* balancing is not required if *Complete Auto*'s apportionment prong is satisfied).

[8] Because the trial court upheld Kentucky's tax exemption on the ground that the Commonwealth was acting as a market participant, it did not reach the question whether the exemption satisfied *Pike*'s balancing test. *See* Pet. App. 18a–19a. Likewise, because the Kentucky Court of Appeals invalidated the exemption on the ground that it discriminated

First, Kentucky's tax exemption furthers several legitimate government objectives. It reduces the interest rate that Kentucky and its political subdivisions must pay when they issue bonds. It devolves greater power over the Commonwealth's fiscal affairs—how much money to spend, and which projects to fund—to local governments, which are better positioned to respond to their respective communities' needs. And it encourages Kentucky citizens to become personally invested in the construction of the Commonwealth's infrastructure, and indeed its future—its schools, universities, roads, utilities, hospitals, and low-income housing.

Second, the exemption's economic impact is not properly understood as a "burden on interstate commerce," let alone a burden that is "clearly excessive in relation to its putative benefits." The principal economic effect of the exemption is to alter the residential distribution of those persons holding Kentucky municipal bonds. It creates a financial incentive for Kentucky citizens, when they are purchasing municipal bonds, to purchase Kentucky bonds rather than those issued by another State. As a result, the proportion of investors holding Kentucky municipal bonds who are Kentucky citizens is substantially greater than it would be absent the exemption. The same is almost certainly true, to greater and lesser degrees, for all 42 States that offer a tax preference for the interest earned on in-state municipal bonds.[9] This ex-

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against interstate commerce, it did not address the *Pike* balancing question, either. *See* Pet. App. 4a–11a. Thus, no court has evaluated the exemption's local benefits or its impact on interstate commerce. For the reasons stated *infra*, we believe that, as a matter of law, the exemption's impact on interstate commerce is not a cognizable "burden" for purposes of the dormant Commerce Clause, and that this Court should therefore uphold the exemption under *Pike*.

[9] The strength of this incentive turns on the taxpayer's marginal state income tax rate. The effect is apt to be strongest for bonds issued by states like California, where the top marginal income tax rate is 9.3

plains the existence of the 400-odd state-specific mutual funds that various investment companies now market to investors.[10]

Though this practical consequence is rather obvious, it is not a "burden on interstate commerce." Although the exemption steers more Kentucky residents towards Kentucky municipal bonds, the Commonwealth's relationship to its residents is qualitatively different than that between a typical debtor and its creditors: It is the relationship between a sovereign and its citizens. "[A]s the guardian and trustee for its people," *Atkin* v. *Kansas*, 191 U.S. 207, 222 (1903), Kentucky has a strong interest in encouraging its citizens to be more than just consumers of the State's public services. Like any sovereign, it naturally desires its citizens to be genuine *stakeholders* in the Commonwealth and its municipalities

An investor's decision to purchase a municipal bond issued by his or her home State is also distinctive from the investor's perspective. After all, it is Kentucky citizens who will directly benefit from the projects financed by Kentucky's municipal bonds, and it is Kentucky citizens who, through their tax dollars, will pay off the interest on these bonds. *Cf. Reeves, Inc.* v. *Stake*, 447 U.S. 429, 442 (1980); *United Haulers*, 127 S.Ct. at 1797. A citizen's decision to invest in his or her own State therefore implicates important, non-financial considerations that are inapplicable to other commitments of capital. For all of these reasons, the fact that Kentucky taxpayers are more heavily invested in Kentucky

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percent, while it less significant for bonds issued by states like Connecticut, where the top marginal rate is 5 percent.

[10] According to the Investment Company Institute, at the close of 2006 there were 482 single-state municipal bond mutual funds with combined assets totaling $155 billion. *See* J. Mysak, *Trash-Hauler Case Muddies Water for Municipal Market*, Bloomberg, May 9, 2007, available at http://www.bloomberg.com/apps/news?pid=20601039&sid=aaVU49WiUSFs&refer=columnist_mysak (last visited July 16, 2007).

municipal bonds—both literally and figuratively—is not a "distortion" of interstate commerce. Instead, it is a natural and salutary consequence of the Nation's federal structure.

Moreover, Respondents' arguments about the beneficial economic effects that would flow from invalidating Kentucky's tax exemption are empirically unsupported and logically flawed. For instance, Respondents assert that, without theses tax exemptions, States "will compete for investors' dollars . . . on the merits of the projects funded by the investment sales," and that, "[a]s a result, the market will provide incentives for governments to be more careful in selecting and funding projects through bond sales." Brief in Opp. 11 n. 5. But that incentive already exists, and strongly so. For purposes of assessing the States' incentives, what matters are the effects of changes in their creditworthiness *at the margin*. Because the state tax exemption is largely capitalized into municipal bonds' yields, the tax exemption—while lowering the interest rate that state and local governments must offer—does nothing to diminish the *marginal* importance to them of remaining a good credit risk. Stated differently, a change in a state or local government's bond rating in a State with an exemption like Kentucky's is apt to have the same impact on that government's borrowing costs as it would absent the exemption.

Finally, the economic impact attributable to Kentucky's tax exemption is quite unlike the harms that this Court has found to constitute "clearly excessive" burdens on interstate commerce in its prior applications of *Pike*. It is not an idiosyncratic state regulation that, when combined with the laws of surrounding States, clogs the channels of interstate commerce. Cf. *Kassel* v. *Consolidated Freightways Corp. of Del.*, 450 U.S. 662 (1981); *Raymond Motor Transp., Inc.* v. *Rice*, 434 U.S. 429 (1978). It is not a law that operates extraterritorially, regulating commercial transactions that occur in other States. Cf. *Edgar* v. *MITE Corp.*, 457 U.S. 624

(1982). And it is not an explicit embargo that prohibits private businesses from transporting certain goods across state borders, as was the case in *Pike* itself. See 397 U.S. at 139.

Kentucky's tax exemption represents a preference by a sovereign for itself, in selling to its own citizens, over other sovereigns. Its effects are simply not comparable to anything this Court has previously held to be an impermissible burden on interstate commerce.

CONCLUSION

The judgment of the Kentucky Court of Appeals should be reversed.

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